Islamic Banking Principles Applied to Microfinance

Case Study: Hodeidah Microfinance Programme, Yemen

January 2002

Table of Contents

Foreword

Our interest in Islamic Banking dates to the earliest days of the MicroStart Programmeme in Morocco, Bahrain, Yemen, and later Egypt. In 1998 UNDP's Regional Bureau for Arab States, together with the World Bank's Middle East and North Africa Region published a Technical Note titled *An Application of Islamic Banking Principles to Microfinance.* This study brought new energy to a microfinance community interested in exploring how Islamic Banking principles joined with microfinance best practices might open avenues to serve poor and low income households who may not consider traditional, interest-based commercial loans.

As our experience grew, there was a call to go beyond principles and deepen our understanding of the *practice* of joining microfinance and Islamic Banking. In this paper, Mr. Ahmed Al-ZamZami and Ms. Lorna Grace focus our attention on the concrete example of the Hodeidah Microfinance Programme in Yemen. We are grateful to the authors for presenting the uniqueness of the Hodeidah microfinance operations in such an informative and analytical. They allow us to view conventional measures and principles of microfinance in light of these innovations in Islamic Banking.

This paper was commissioned by the Special Unit for Microfinance as part of the curriculum development for the workshop "From Donations to Investments: Donors and Sustainable Microfinance" that was held in Cairo, Egypt in November 2000. We acknowledge with gratitude the support of the UNDP Regional Bureau for Arab States, particularly Mr. Ali Al-Za'tari, the continued support of CGAP, and the work of Ms. Deena Burjorjee from SUM who provided clear direction and commitment to the project.

Heather Clark
Director,
Special Unit for Microfinance (SUM)
United Nations Capital Development Fund
January 2002

Introduction

Although microfinance has been utilized in almost all parts of the world, some areas/regions work especially hard to adapt certain basic microfinance tenets to their own unique circumstances. Social, economic and religious restrictions have often led to creative ways of adapting principles of microfinance to the realities of the environment.

Countries in which conservative Islamic practices hold sway often discourage the practice of charging interest. Depending on how strongly these beliefs are held, microfinance institutions have adapted in a variety of ways. Where these beliefs are not as pervasive, institutions may make cosmetic changes to their operations and products, such as changing the term "interest" to "service charge". In other cases where these beliefs are fundamental and widespread, more extensive adaptations have had to take place, which affect the core of an institution's systems, operations and beliefs.

Types of Islamic Banking

Islamic financial practices are founded on the belief that money is not an earning asset in and of itself and therefore cannot earn interest.

"Islamic religious law --- that is, *Sharia*---emphasizes ethical, moral, social and religious factors to promote equality and fairness for the good of society as a whole. Principles encouraging risk sharing, individual rights and duties, property rights, and the sanctity of contracts are all part of the Islamic code underlying the banking system."[1]

However, the prohibition of interest has been interpreted differently by the scholars of *Sharia* and there are various schools of thought on the topic. By no means do all Muslims or Muslim countries practice any form of Islamic banking.

There are three widely used Islamic banking methods:

Musharaka: Financial transactions in which the investment made is based on equity participation. All partners have a financial stake in the company and the right to a pre-determined percent of the profits. Investment is not required to be paid back at a predetermined date and the bank remains a partner in the operation.

Mudharaba: Owner of the capital is the bank or moneylender, who is able to determine a percent of profit. Like Musharaka, the actual return is unclear as it depends upon the final profit. The major difference between Mudharaba and Musharaka, is that in the case of Mudharaba the entrepreneur is not required to invest his/her own capital and the total loan is paid back at a predetermined date (along with any profit). The partnership is then closed.

Murabaha: Financial product, similar to trade finance in the context of working capital loans and to leasing in the context of a fixed capital loan. The institution buys goods and resells them to entrepreneurs for the cost of the goods plus a fixed markup for administration cost. The financing entity owns the goods until the last installment is paid.

When profit sharing is the source of return as in the first two methods, the lender is actually an investor, taking on a portion of the business risk of the enterprise. Additionally, profit sharing adds a distinct complexity as accurate and valid books need to be available and maintained. In the third method, murabaha, the financing entity takes on more of a lending role, with a fixed amount of risk and fixed amount of return. Although the success of the business is integral to eventual repayment of the financed amount (as in any financing), it does not determine the total return to the financing institution.

Murabaha is a more suitable financial product to adapt to the needs of the typical microfinance client in the region. It does not require conventional collateral for credit (the commodity or asset being financed serves as collateral). Nor does it require accounting records, something not readily available from clientele in areas where the literacy rate is low. However, its use does manifest challenges for a microfinance institution (MFI). To better elaborate on these challenges, this paper outlines the Hodeidah Microfinance Programme (HMFP), an MFI located in Hodeidah City on the coast of Yemen in the Arab peninsula. The programme follows conservative Islamic banking tenets and uses the murabaha method adapted for its target clientele.

---

1 "An application of Islamic Banking principles to Microfinance. A technical note." Rahul Dhumale and Amela Sapcanin. Regional Bureau for Arab States, UNDP and Middle East and North Africa Region, World Bank.

Hodeidah Microfinance Programme

Yemen adopted Islamic banking in 1996 and currently there are three formal Islamic banks in the country.

The Hodeidah Microfinance Programme (HMFP) began in the fall of 1997, after a market study was conducted in the city of Hodeidah. Hodeidah is a port city with a population of nearly half a million. It is characterized by an active economy based on trading, fishing, food production, small industries, handicrafts and transportation. In the early 1990s, during and after the Gulf War, many families returned to this city from Saudi Arabia and other Gulf States. Now, roughly 30 percent of the total population in Hodeidah are returnees, a key market segment for HMFP. Much of the population has conservative Islamic beliefs. The population studied showed a clear preference for the methodologies of Islamic banking in terms of receiving credit.

HMFP is the first microfinance project of its kind in Yemen and consequently has had to develop its human resources itself. It had 1770 active clients as of June 2000, 23 percent of whom were women and $350,000 in outstanding loans.[2] The average loan size is 38,000 Yemeni Rial (YR) ($240 US dollars).[3] There is a cycle of loans the clients go through but each level has a wide scope. The first loan can be up to 50000 YR ($300 US). The maximum loan for the final level is 250,000 YR ($1500 US).

HMFP uses a group-based methodology. Loans go to individuals within the group and group members are expected to provide guarantees and some support to one another. All group members get loans at the same time. Group members are not confined to the same loan amounts or the same activities, although loan amounts need to be within the range of the cycle set by HMFP. There is also a small percentage of individual loans (10 percent).

Although it was originally expected that the group would provide guarantees in the strictest sense of the word, i.e. make up missed payments of group members, in reality, they rarely do. Instead they provide more of a “moral” guarantee and also take on some responsibility for tracking down errant members as needed. They also sign a document that guarantees other member’s loans. Groups do not meet regularly.

The procedure is as follows: upon receipt of the loan application, the credit officer investigates the group and does a feasibility study for their activities. From this study, the officer can estimate the precise loan amount. If the feasibility study is positive, the client should identify items (commodities/equipment) needed from the wholesaler and negotiate a price. The credit officer then purchases items from that source and resells them immediately at that price to the client.

2 Including capitalized interest.

3 Including capitalized interest

Market Access and Participation

Target Group

The project may lend to anyone in the target group who is poor, lives in the districts of operation and has an economic activity. Although early in the programme's life, start-up businesses were a major focus, risks of financing these startups were recognized early and currently there is a cap of 10 percent of disbursements on lending to startups.

Typically the female clients are involved in different activities such as selling grocery items, selling fish, making bread, and sewing. My colleague wrote this and I'm not sure what he meant. Most women who participate are widows with children. As a strategy for attracting and keeping a woman clientele, the programme uses women field officers to serve women. These field officers live in the district where the women live, so they are aware of where potential clients live and do business[4]. Women field officers interact with both clients and suppliers on their own.

Women form lending groups mostly with other women. Although women have smaller loan sizes on average than men, as is typical of much MFI lending, their performance relative to men is similar in terms of repayment.

Perception and Acceptance

The programme was developed based upon an extensive market survey during which potential clients were interviewed to determine their preference for the type of credit. In spite of this survey, when the programme was first introduced, some clients were afraid to take the loan due to their religious beliefs. Others (not always clients) felt that since the programme targets the poor, it should give soft loans because the implied service charge rate is higher than what commercial banks charge.

Some religious/mosque speakers announced that the project practices riba (charging of interest) which is prohibited in Islam. However, when the project management described details of the transaction, most of these speakers felt the product did adhere to the murabaha methodology and retracted their statements.

Although traditional banking products have been available in Yemen for many years (and are still the predominant type of finance), many people, especially the poor, have been reluctant to take credit, in part due to religious beliefs. However, openness to credit varies from region to region. In Aden, a less conservative city, people are less reluctant to take credit, even the traditional form of credit.

Some clients were able to get supplier credit from wholesalers in the past. In such cases a client would have an introduction from another member of the community. Clients fortunate enough to have supplier credit often had to pay more for credit than if payment was made in cash (from the buy-sell transaction). Most borrowers prefer to use HMFP as the suppliers did not always give sufficient credit to fill demand, nor would they sell on credit if they had brisk demand for the product.

Microenterprise vs. Small Enterprise

Although HMFP does not specifically define the distinction between micro and small enterprise, based on the average loan size disbursed the primary market is the microenterprise. Some financed micro-businesses have grown to a larger size and when this occurs, and the lending cap is reached, the programme refers the client to a bank.

4 Most women run businesses which are located in the household.

As murabaha is not an Islamic banking product which requires profit-sharing, its use eliminates the need for written records, often unavailable at the microenterprise level or if available (20 percent of HMFP clients keep books), the client may be unwilling to share them. Additionally, as financing is not based on profit sharing, the return to the institution is based on a well-defined contract, with pre-defined amounts. Therefore there is no opportunity for abuse on the part of the client through inaccurate or false record-keeping. Finally a fixed contract and absence of profit sharing implies a less complicated process and thus a lower cost to the institution to implement.

Murabaha can be used for both working capital and fixed asset financing, thus widening the appeal of the product, especially as a client develops economically. In either case the lender "owns" the financed goods/assets, until the loan is paid in full. Thirty percent of all loans are for fixed asset financing.

Challenges

Accounting and Financial Issues

HMFP has two elements of accounting/finance, which differ from most microfinance organizations. Both have implications for content of financial statements. The first is capitalization of the service charge expected upon disbursement, which affects the balance sheet. The second is the absence of the "principle of interest" on outstanding loan balances affecting yield on the portfolio and thus income earned.

Amortization of Service Charge/Principal

As interest (the concept of paying for the time value of money) is not considered in murabaha, the question of amortization does not exist. The contract between the borrower and institution is for a fixed amount to be paid in equal installments. Installment amounts are calculated in advance and include both the initial amount extended as well as a service charge. The service charge is nominally based on the amount loaned as well as the term in which installments are to be paid back. HMFP collects installments primarily on a monthly basis, although shorter installment periods also take place. The "service charge" or agreed cost of the buy-sell service is a fixed amount based on the expected term of the loan and frequency of installments. At HMFP it is based on a 2 percent flat monthly charge.

Table 1. Sample Loan Installments

Actual Cash Flow (YR)

Period	Principal from (to) Client	Fees/Service Charge	Net Cash Flow
0	(20,000)	50	(19,950)
1	3,750		3,750
2	3,750		3,750
3	3,750		3,750
4	3,750		3,750
5	3,750		3,750
6	1,250	2,400	3,650

Periods/Year = 12

Periods in Loan = 6

The six installments are essentially equal. The first five installments are principal only. The final installment (or more depending on the term of the loan) is the service charge plus remaining principal.

In a traditional MFI, the installments are equal, but usually the client pays a portion of the principal and interest in each installment (either through amortization or a fixed split between interest and principal).

Implications:

❖ From an accounting perspective, disbursement involves a disbursement of both principal receivable and service charge receivable. Thus service charge is "capitalized" on the balance sheet through the lifespan of the loan and normally included in the portfolio outstanding account. This receivable is only reduced as the service charge comes in (at the end of the loan term). For example, in the loan noted above, the expected service charge of 2400 YR is posted to "client account" (which includes both service charge receivable and portfolio outstanding) upon disbursement. See Table 2.

❖ The loan portfolio, and thus balance sheet, at any one time, is overstated in terms of assets, and depending on the season and balance sheet composition, it has been as much as 21%. At year end December 1999, the portfolio outstanding as stated in the financials was 58,554,037 YR of which service charge receivable, both due and not paid and not due, comprised 12,142,979 YR.[5]

Table 2. Sample Accounting Entries

	Dr.	Cr.
Loan Disbursement		
Client Account (A)	22400	
Cash (A)		20000
Deferred Income (L)		2400
Installment Payment		
Cash (A)	3750	
Client Account (A)		3750

5 Also including service charge due but not paid, i.e.late.

Until Principal is paid in full then:		
Service Charge		
Cash (A)	2400	
Client Account (A)		2400
Deferred Income (L)	2400	
Murabaha Income (I)		2400

(A)-Asset, (L)-Liability, (I)-Income

In most traditional MFIs, interest income is not capitalized as an asset on the balance sheet upon disbursement of the loan. Thus, assets would not be overstated for this reason.

Income Earned

A major tenet of the murabaha methodology is the existence of a fixed contract for the service. This contrasts with conventional microfinance, where the client enters into a contract where the cost for the service could change depending on repayment performance. When a murabaha loan is issued, the service charge is based on a fixed loan term and fixed installment schedule. When these parameters are violated, there is no recourse in terms of penalty to compensate for the fact that the loan is outstanding longer than expected or that the loan installment is late.

In a traditional MFI, late fees and penalty interest is a critical motivation for repayment. However, in addition to the operational implications this has in terms of the importance of effecting prompt repayment, it also has implications for the income statement.

The service charge is received at the end of the loan period, thus, murabaha income is credited only at the end of the loan, and not over the life of the loan. Posting income at the end of the loan is highly conservative, as the period over which it was earned has passed. However, HMFP is reluctant to accrue income over the life of the installments, as it appears then to be similar to the concept of interest. However, there has been no discussion as to why HMFP does not take in the service charge initially as a prepaid fee, except that it would not adhere to conservative accounting principles.

The implication of receiving the murabaha income/service charge at the end of the loan term is that it can lead to wide swings in income depending on the seasonality of the portfolio. This contrasts to more traditional MFIs, where even if there is seasonality and varied disbursement patterns of the portfolio, interest income is accrued on a regular basis. Thus swings in income are not so pronounced.

Another element of the murabaha income is that it is fixed per loan. Consequently if the loan is outstanding longer than the specified term the yield on the loan then declines. If the portfolio as a whole has an effective term longer than the contracted term then the yield of the portfolio declines. Additionally, even delays in installments within the term will reduce the yield on the loan and consequently the portfolio.

Table 3. Effective Yield on Loan--Accounting Treatment

Period	Principal balance on books	Fee income from client when recognized
1	20,000	50
2	16,250	
3	12,500	
4	8,750	
5	5,000	
6	1,250	2,400

Yield (service charge + fees) on Loan: **34.09%**

This approach is in contrast to a traditional MFI, where the client is charged not only interest on the remaining outstanding or late principal installment, but in some institutions, a penalty interest or fee could be charged.

Yield on the portfolio (fees and service charge over average portfolio) as opposed to an individual loan is also a function of disbursement patterns. The nature of the swings in disbursements at HMFP which are heavy during the holiday/religious periods, coupled with the unique nature of the service charge occurring at the end of the loan, means that as the portfolio grows or contracts, the yield changes, regardless of how the portfolio is performing in terms of quality.

In the six months from January 2000 to June 2000, yield on the portfolio was approximately 23 percent well below the optimum yield. As the portfolio remained at approximately the same value over this period, yield on the portfolio would be a reasonable reflection of an average return to the portfolio. However, this bears further investigation as to the causes of the lower performance.

In contrast to late payments or longer effective term than intended, prepayments work in the institution's favour in terms of effective yield on the portfolio. When clients pay off all installments early, the service charge or murabaha income remains the same. Thus prepayments would increase the effective yield on the loan portfolio.

During the initial years of operations, HMFP had a high volume of prepayments as a percentage of total payments. This has dropped from a high of 37% at one point but they remain a factor. Although prepayments are positive from an income perspective they often cause complications for management and planning. HMFP has tried to reduce the percentage of prepayments.

Planning and Forecasting

Both the service charge capitalization issue and income patterns make financial analysis and forecasting challenging as HMFP does not fit into the conventional MFI mold. This is particularly noticeable when developing forecasts for the organization. While HMFP is able to use a traditional forecasting model such as *Microfin*,due to the peculiar nature of its non-amortization of service charges, heavy adaptation has been required. With the exception of not having an additional charge on

overdue principal, predicting cash flow, however, remains the same under the murabaha method.

Operational Issues

Monitoring and Risk Management

Portfolio quality and the eventual recovery of the loan are determined by the credit process ranging from promotion, screening, application, analysis, approval (pre-loan), through post-disbursement management such as collection, delinquency follow-up, and qualification for additional loans. These elements are as integrated into the murabaha product as they are in "standard" microfinance products.

However, the borrower or murabaha client incurs no penalty for late payment (except for fees and transportation costs charged for legal followup)—one of the principle motives for on-time repayment. Nonetheless, other incentives for repayment remain in place:

- attraction of the possibility of additional, larger loan
- programme is rigorous about going after delinquent borrowers
- regular equal installments enforce discipline among borrowers

The primary element monitored for credit quality at the field level is arrears, which can include service charges receivable near the end of the loan term. HMFP has very good credit quality. However at the early stages of the programme's life, as they were developing systems and procedures and expanding rapidly, credit quality was an issue. Table 4 shows the portfolio quality trends since July of 1999.

Table 4. Portfolio at risk (>30 days) as a percentage of outstanding loans

Month	PAR>30 days (%)
July 1999	3.5
August 1999	3.2
September 1999	2.7
October 1999	3.3
November 1999	3.0
December 1999	1.7
January 2000	2.3
February 2000	2.7
March 2000	4.2

June 2000	3.0

N.B. PAR over 30 days has climbed as of June 2001, primarily due to change of management.

Control

A significant operational difference separating the murabaha system from the conventional microfinance system is the disbursement transaction. Effectively the client does not handle cash at disbursement but rather the transaction is between the institution (represented by the field officer) and the purveyor of the commodity or fixed asset. As such, the institution bears the risk of this transaction. The transaction is normally done on a cash basis. Consequently the field officer may carry large amounts of cash to suppliers or markets, and the institution is susceptible to risk of theft by an outside party or even its own staff.

To minimize the impact of these concerns, certain levels of cash disbursement require more than one field officer present or they restrict their disbursement to a small number of clients, thereby carrying only cash for three to four transactions. Each of these restrictions/controls imply additional costs, not generally incurred in many MFIs where the clients come directly to the institution to obtain their disbursement and are thus the ones to take the risk.

These additional control issues, have caused HMFP to consider creating an internal auditor position. Although recommended in best practices of microfinance, an internal auditor position is usually a luxury found only in a larger MFI. Management believes that the nature of the transactions, and the risks which they pose to the institution, require further review. Presently an external auditor serves this purpose in a limited way.

Performance

Efficiency

The nature of murabaha financing is such that, although much of the other costs of lending and follow-up are incurred as in conventional microfinance, the additional cost of the buy-sell mechanism clearly adds to the programme's operating costs. Credit officers are required to prepare a detailed feasibility study in every loan case, which then serves as the basis for murabaha financing. They are also required to go to the market to purchase the commodity or fixed asset and exchange cash for it.

HMFP is a very new programme with its first loan being issued in early 1998. The original strategy was to expand quickly in an effort to build outreach and self-sufficiency, and consequently HMFP currently has eight districts covered and 18 field officers.

Table 5. Selected productivity and efficiency data

	Dec. 1998	June 1999	Dec. 1999	June 2000	Dec. 2000	June 2001
# of Clients/Field Officer	75	61	122	98	100	104
Portfolio Outstanding[6]	8,137	5,769	18,267	15,339	16,844	18,497

6 Not including interest recievable.

/Field Officer ($)						
Administrative Efficiency[7]	61.3%	65.3%	52%	40%	41.5%	26.6%
Operating Efficiency [8]	70.7%	78.4%	52%	40%	41.5%	26.6%

Note: Administrative Efficiency and Operating Efficiency are the same in December 1999 through June 2001 due to no cost of funds and no loan loss provisions taken during these periods.

Although the trend is certainly positive, HMFP has a long way to go before achieving optimum efficiencies. In June 2000 the ratio of number of clients per field officer declined due to the addition of two new field officers during that period, although it rebounded slightly as of June 2001. Total number of loans declined (from 1951 in December 1999 to 1770 in June 2000, peaking again in June 2001 at just over 2,000), likely due to seasonal lending.

Management believes that the optimum number of clients per field officer is 150. This is actually a relatively low caseload for a semi-urban programme. Although the optimum level target might increase, with the current intensive screening and application process and the buy-sell mechanism related to the murabaha financing system, a caseload of 150 may be realistic. Additionally, there are plans to aggregate the buy-sell mechanism, by placing it in the hands a very few specialists, thus freeing up the loan officers' time.

Sustainability

Although HMFP has a long term goal and mission to be a sustainable organization, in terms of both staff, governance, structure and financial elements, they are currently subsidized. All loan funds come to HMFP as a grant from the Yemen Social Fund for Development. Additionally, they receive a grant for operations at the beginning of each year, based on a budget. They currently are tracking the following ratios:

Table 6. Self Sufficiency

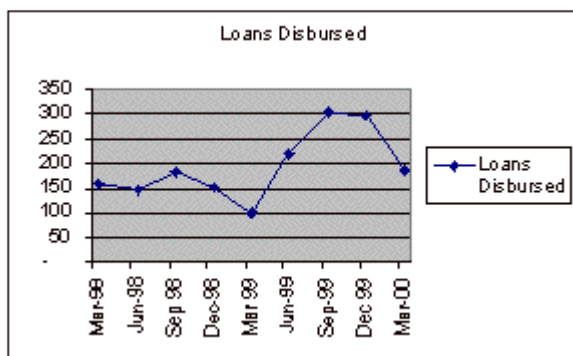
	Dec. 1998	June 1999	Dec. 1999	June 2000	Dec. 2000	June 2001 [9]
Operating Self-Sufficiency[10]	29%	73.3%	66.7%	70.3%	81.2%	97.1%
Financial Self-Sufficiency[11]	22%	53.9%	51.9%	52.3%	65.7%	73.6%

7 administrative costs excluding financial costs as % of avg. net portfolio.
8 total operational costs as % of avg. net portfolio.
9 Interim year figures for 2001 do not include depreciation or provisions, which are taken at the end of the year.
10 Income earned divided by total operating costs, including loan losses and cost of funds.
11 In June 2000, inflation rate used was 10% (six months=5%), market cost of capital was 16% (six months=8%). Income earned divided by adjusted operating costs (adjusted for inflation impact on equity less fixed assets and market cost of funds).

The above calculations use the strictest definitions of self-sufficiency. The June 1999 and December 1999 results include sizeable income from investments. Although MFIs are likely to have certain investments at any one time, HMFP's sizeable pre-funding meant that income from investments over the January through June period (1999) and the June through December period (1999) was 57.7 percent and 28.7 percent of the total income respectively. In the figures for June 2000, the ratio includes investment income, which comprises 16 percent of total income (a more realistic figure).

The above ratios should be placed in context. Over the last fiscal year ending June 2000, the institution absorbed costs of the initial rapid expansion as the programme grew to cover all districts. All loan loss provisions are taken at the end of the fiscal year, if necessary. Interim reporting periods would not have any loan loss provisions included in its operating costs (and in June 2001, no depreciation).

Finally, lending is typically seasonal in Hodeidah. Most of the seasonality revolves around Ramadan and Eid. The following chart shows disbursements on a quarterly basis.

Chart 1. Number of loans disbursed

Naturally, performance indicators would also track seasonal variations, especially considering the patterns of murabaha income inflow.

The prospect of sustainability remains an open question for HMFP. Given their added costs due to this type of financing, the lower productivity per staff unit has heavy consequences on their cost structure. Additionally lower effective portfolio yield puts pressure on the revenue side. These two issues must be resolved before sustainability can be reached.

Enhancing Value to Client

HMFP works in a competitive vacuum, relative to the service it offers. Even so, it has a low number of repeat borrowers. HMFP has a fairly extensive information database, which can be examined to determine the rate of repeat clients.

The number of loanees who finished loans in the first six months of 1999 (January to June)and then obtained new loans either during that period or in the following six months (July to December) is shown in Table 7.

Table 7. Retention rate June 1999 through December 1999 by gender

Gender	Number of finished loans in first half of 1999	Number of renewed loans	Client Retention ratio
Male	671	274	41%
Female	144	64	44%
Total	**815**	**338**	41%

The number of loanees who finished their first loan in the first six months of 1999 (January to June)and then obtained new loans either during that period or in the following six months (July to December) is shown in Table 8, along with the retention rates for subsequent loan cycles.

Table 8. Retention rates June 1999 through December 1999 by gender and by loan #

Loan #	Gender	Number of finished loans in first half of 1999	Number of renewed loans	Client retention ratio
1	Male	551	195	35%
1	Female	123	54	44%
2	Male	111	72	65%
2	Female	22	11	50%
3	Male	18	15	83%
4	Male	3	3	100%
5	Male	2	2	100%
	Total	**830**[12]	**352**	**42%**

Table 8 shows that women are marginally more likely to obtain a new loan with a 44 percent retention ratio through all levels of loans. However, after the second loan, women are *less* likely than men to renew. Overall retention ratios get higher as clients gain loan experience and understand the process.

12 There are some discrepancies between tables as table 8 shows renewals within the first six months as well as the last six months. Effectively, a client could show up twice (or maybe three times) in the table if loan terms were short enough or if prepayments were made.

Clearly this analysis is limited as it shows only one period. It has been assumed that most people, after repaying a loan, are more likely to renew within a few months rather than after one year. However, there may indeed be some clients who are overlooked in this review. For example, there may be clients who take seasonal loans only. Tracking this ratio on a rolling basis would give more accurate results.

Management has conducted an informal client survey to determine the cause of the low retention rate. The most often reported reasons were the following:

- Programme refused the client
- Reached self-sufficiency
- Worried they were not going to be able to comply with loan terms
- Emergency or problems in business/home
- Activity stopped
- Clients have other duties
- Service charge was too high

Although this study was not scientific or systematic, it does point to some recurring issues. Points such as "reached self-sufficiency" and "worried they were not going to be able to comply with the loan terms" may infer that some clients are not used to credit and perhaps uncomfortable with its use. Reasons such as "clients have other duties" or "activity stopped" may refer to some clients who have salaried employment.[13] There could be many reasons for dropout, including attitudes to being in debt, nature and importance of the business to the client, perhaps the cost of the credit and the seasonality of the activities.

HMFP does try to focus on providing a good service or product to the client, by providing a culturally and religiously acceptable financial product in a timely manner, with little or no collateral. Although HMFP expanded quickly in the early days, it has chosen to retrench and concentrate on quality over the last year, giving it a solid base for future expansion, which may include new product lines as well as more extensive outreach.

13 Significant numbers of HMFP's clients have salaried government appointments.

Conclusion

Islamic banking principles applied to microfinance pose several operational and financial challenges to an MFI. Throughout the paper the differences between the practices and processes of a traditional MFI and that of an MFI applying Islamic banking principles to microfinance have been highlighted.

Tables 9 and 10 outline some of the similarities and differences between ideal practices of a traditional MFI and those of an MFI practicing relatively strict Islamic banking practices as in the case of HMFP.

Table 9. Principles of Financially Viable Lending to Poor Entrepreneurs

Principle	Murabaha adaptation	Common to MFIs and HMFP
Offer services that fit the preferences of poor entrepreneurs	Product and process do not allow relatively unrestricted use of funds Product requires more extensive application including cash flow >Fixed asset and working capital loans offered	Short-term loans Repeat loans >Small loans Outlets close to customer Loan installments compatible with cash flow of business
Streamline operations to reduce unit costs	Application form can be lengthy Potentially lower productivity per staff due to application process Disbursement is through buy-sell mechanism	Standardized process Inexpensive offices Staff selected from local communities
Motivate clients to repay loans	No additional service charge on late installments	>Joint liability groups >Access to further loans, increasing loan sizes >Staff credit culture
Charge full-cost interest rates and fees		>Fees and service charge to cover full costs of lending

Table 10. Other comparisons with traditional microfinance operations

Element	Murabaha/HMFP	Traditional MFI
Accounting	>No amortization of service charge over life of loan >Lump sum at end >Capitalization of service charge, overstatement of assets	>Amortization or equal split of interest over life of loan >No capitalization of interest
Patterns of Disbursements	>Significant impact of seasonality on income	>Some impact of seasonality on income
Planning/Analysis	>Does not fit into typical forecasting models >Data needs to be adjusted for standard analytical formats	
Control/Risk	>Field officers handle disbursement >Early consideration of the post of internal auditor	>Client bears risk after receiving disbursement >Internal auditor post usually comes with advanced size of the institution